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Constitutional and Statutory Limits on the Power to Tax

By JAMES E. SABINE*

Drawing the appropriate boundary between state power to tax and the limitations imposed by the federal constitution has long been a function of the United States Supreme Court. Recently Congress has entered upon the scene and laid down some ground rules regarding state taxation of income derived by out-of-state vendors from the sale of tangible personal property. This legislation has provided certainty in some respects but has brought with it some questions of statutory interpretation.

The states, themselves, at times have provided by statute for a lesser exercise of state power to tax than that deemed permissible by the Supreme Court under the federal constitution.

In the discussion which follows, the focus will be upon the federal constitutional provisions most frequently considered by the Supreme Court in relation to state taxing power—the commerce clause and the due process clause of the fourteenth amendment—the recently enacted federal legislation and some of the pertinent California statutes, decisions and administrative interpretations concerning the extent to which the power to tax is or may be exercised.¹

I. Commerce Clause

A. Court Decisions

In considering the extent to which the commerce clause is a restriction on state taxation, attention must be given to the form or inci-

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(The opinions expressed in this article are those of the author and do not necessarily reflect the views of the Attorney General's Office.)

¹ In this article no attempt is made at a comprehensive statement of the federal constitutional law as it has developed in relation to state taxation. The approach rather is to provide a framework of some of the basic principles which have evolved under the commerce clause, the due process clause of the fourteenth amendment of the federal constitution and to consider the application of these principles to the California system of taxation under the Personal Income Tax Law (CAL. REV. & T.C. §§ 17001-19500) and the Bank and Corporation Tax Law (CAL. REV. & T.C. §§ 23001-26481). Along with this there will be some discussion of limits self-imposed by California in its statutes.

dence of the tax.² The draftsmen of the California tax laws had the insight to recognize this and, accordingly, provided for a *franchise tax measured by net income* applicable to corporations which engage in at least some intrastate business in California and a *tax on net income* applicable to corporations which engage exclusively in interstate commerce.³ The significance of the distinction between a privilege tax and a net income tax⁴ is apparent from the following brief summary of United States Supreme Court decisions.

Corporations engaged in the taxing state in both intrastate commerce and interstate or foreign commerce may be subjected to a franchise tax measured by net income reasonably attributable to the taxing state, even though part of the income so attributable is from interstate or foreign commerce. This is true whether the corporation is domestic⁵ or foreign.⁶

Corporations may not be subjected to a franchise tax on the privilege of doing business if they engage exclusively in interstate commerce.⁷ They, however, may be subjected to a net income tax on that portion of their net income reasonably attributable to the taxing state even if they are foreign corporations and are engaging exclusively in interstate commerce.⁸

In *Northwestern States Portland Cement Co. v. Minnesota*,⁹ decided in February, 1959, the United States Supreme Court removed any lingering doubt as to state power to tax net income derived exclusively from interstate commerce. Within approximately six months

² Barrett, "Substance" vs. "Form" in the Application of the Commerce Clause to State Taxation, 101 U. PA. L. REV. 740 (1953). Sabine, *Interstate Commerce and State Taxation in the Supreme Court, 1950 Term*, 26 CAL. S.B.J. 347 (1951). Sabine, *State Franchise and Income Taxation of Corporations Engaged in Interstate Commerce*, REVENUE ADMINISTRATION 1957 (National Association of Tax Administrators, Chicago). "... The incidence of the tax provides the answer" *Spector Motor Service v. O'Connor*, 340 U.S. 602, 608 (1951).

³ CAL. REV. & T.C. §§ 23151, 23501. The opinion of the California Supreme Court in *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 708, 166 P.2d 861, 863, (1946), explains the difference between a net income tax and a franchise tax and the function served by each.

⁴ Brown, *The Nature of the Income Tax*, 17 MINN. L. REV. 127 (1933).

⁵ *Matson Nav. Co. v. State Board*, 3 Cal. 2d 1, 43 P.2d 805, *aff'd*, 297 U.S. 441 (1935).

⁶ *Butler Bros. v. McColgan*, 17 Cal. 2d 664, 111 P.2d 334, *aff'd* 315 U.S. 501 (1941).

⁷ *Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951).

⁸ *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 166 P.2d 861, *aff'd per curiam*, 328 U.S. 823 (1946).

⁹ 358 U.S. 450 (1959).

after the decision, however, a federal statute¹⁰ was enacted, limiting

¹⁰ 73 Stat. 555 (1959), 15 U.S.C.A. §§ 381-84 (Supp. 1959).

TITLE I — IMPOSITION OF MINIMUM STANDARD

Section 101. (a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(b) The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to:

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

(c) For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

(d) For purposes of this section:

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.

Section 102. (a) No State, or political subdivision thereof, shall have power to assess, after the date of the enactment of this Act, any net income tax which was imposed by such State or political subdivision, as the case may be, for any taxable year ending on or before such date, on the income derived within such State by any person from interstate commerce, if the imposition of such tax for a taxable year ending after such date is prohibited by section 101.

(b) The provisions of subsection (a) shall not be construed:

(1) to invalidate the collection, on or before the date of the enactment of this Act, of any net income tax imposed for a taxable year ending on or before such date, or

(2) to prohibit the collection, after the date of the enactment of this Act, of any net income tax which was assessed on or before such date for a taxable year ending on or before such date.

Section 103. For purposes of this title, the term "net income tax" means any tax imposed on, or measured by, net income.

Section 104. If any provision of this title or the application of such provision to any person or circumstance is held invalid, the remainder of this title or the application of such provision to persons or circumstances other than those to which it is held invalid, shall not be affected thereby.

to some extent state power to tax income from interstate commerce.¹¹

B. Federal Legislation

State power to impose a net income tax on income derived within the state by any person¹² from interstate commerce is restricted by the federal statute only if the business activities within the state by or on behalf of such person are limited to:

(1) the *solicitation of orders* by such person, or his representative, for sales of tangible personal property, which orders are sent outside the state for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the state;¹³ and

(2) the solicitation of orders by such person, or his representative, in such state in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1);¹⁴ and

(3) *sales* in the state, or the *solicitation* of orders for sales in the state, of tangible personal property on behalf of such person by one or more *independent contractors*, and the *maintenance of an office* in the state by one or more *independent contractors* whose activities on behalf of such person in the state consist solely of making sales, or soliciting orders for sales of tangible personal property.¹⁵

The last mentioned provision signifies that an *independent contractor* may make sales of tangible personal property in the state or

TITLE II — STUDY AND REPORT BY CONGRESSIONAL COMMITTEES

Section 201. The Committee on the Judiciary of the House of Representatives and the Committee on Finance of the United States Senate, acting separately or jointly, or both, or any duly authorized subcommittees thereof, shall make full and complete studies of all matters pertaining to the taxation by the States of income derived within the States from the conduct of business activities which are exclusively in furtherance of interstate commerce or which are a part of interstate commerce, for the purpose of recommending to the Congress proposed legislation providing uniform standards to be observed by the States in imposing income taxes on income so derived.

Section 202. The Committees shall report to their respective Houses the results of such studies together with their proposals for legislation on or before July 1, 1962.

¹¹ Mickey and Mickum, *Congressional Regulation of State Taxation of Interstate Commerce*, 38 N.C.L. REV. 119 (1960); 46 VA. L. REV. 297 (1960); 108 U. PA. L. REV. 1077 (1960).

¹² "Person" as used in the federal statute includes corporation and individual.

¹³ 73 Stat. 555 (1959); 15 U.S.C.A. § 381(a)(1) (Supp. 1959).

¹⁴ 73 Stat. 555 (1959); 15 U.S.C.A. § 381(a)(2) (Supp. 1959). This abstruse provision may be more meaningful if its application is illustrated. The following is an example of a factual situation to which the provision would apply: An out-of-state manufacturer has a prospective customer in the taxing state who is a wholesaler. A representative of the manufacturer solicits orders for the wholesaler from retailers. To fill the orders, the wholesaler then sends its order to the out-of-state manufacturer who fills the order by shipment from a point outside the state.

¹⁵ 73 Stat. 555 (1959); 15 U.S.C.A. § 381(c) (Supp. 1959).

may maintain an office in the state without causing the out-of-state sellers whom he represents to lose the benefit of the statute if his only activities on behalf of the sellers consist of making sales or soliciting orders for sales of tangible personal property.

The scope of the federal statute is limited. *It applies only to income from sales of tangible personal property.*¹⁶ It does not apply, therefore, to income from sales of intangible property. It does not apply to income from services as distinguished from sales. Thus, it does not apply to income from communication or transportation. It does not apply, therefore, to the usual activities of airlines, railroads, trucking companies, newspapers, or radio and television stations. The statute, moreover, does not apply with respect to a domestic corporation or any individual who is domiciled in or a resident of the taxing state.¹⁷

The statute undoubtedly was intended to settle certain questions as to the scope of state power to tax but it raises many new questions of interpretation of the statutory language. A problem that suggests itself at the outset is what guides shall be followed in interpreting the statute. Some of the phrases not defined in the statute, for example, "tangible personal property," have been construed by state courts for other purposes and the state courts have not always been in complete agreement in these interpretations. Shall local decisions govern the interpretation of the federal statute? The United States Supreme Court would have the final say and, since the purpose of the statute is to achieve uniformity, the Court would not be likely to allow differing local interpretations to govern but presumably would announce a basic interpretation applicable in all states.

Here are some examples of provisions in the federal statute which the courts may be called upon to interpret:

1. *Solicitation of Orders*

The word "solicitation" may very well include such activities as radio, television and newspaper advertising, as well as business done by mail or telephone contact.¹⁸ Under the federal statute, the mere presence of solicitors in a state would not enable the state to subject a foreign corporation to state income tax. There is almost universal agreement, however, that the maintenance of a sales office constitutes more than mere solicitation and provides sufficient basis for the imposition of a state tax.¹⁹ This view is supported by the legislative history since a specific provision permitting maintenance of a sales office with-

¹⁶ 108 U. PA. L. REV. 1077, 1084 (1960).

¹⁷ 73 Stat. 555 (1959); 15 U.S.C.A. § 381(b) (Supp. 1959).

¹⁸ 46 VA. L. REV. 297, 314 (1960).

¹⁹ 46 VA. L. REV. 297, 315 (1960).

out incurring liability for tax was struck by an amendment on the Senate floor.²⁰

2. *Sales*

The statute relates to solicitation of orders for "sales" of tangible personal property. Persons merely providing services are not protected by the statute. A problem arises, however, where the sales contract includes a provision for some future servicing, such as installation, consultation, supervision or repairs. The question arises whether a foreign corporation might render itself liable for taxation on all its income derived from the taxing state if, in addition to the solicitation of orders for sales, it renders certain services.²¹

3. *Tangible Personal Property*

To gain the protection of the federal statute, the solicitation of orders must be for the sale of tangible personal property. The statute does not define this phrase. Questions might arise, for example, where such substances as gas or electricity are involved. The phrase "tangible personal property" appears in the sales and use tax laws of many states and there are some borderline situations in which the states are not in complete agreement as to what constitutes "tangible personal property." Since we are here concerned with a federal statute, there no doubt would be strong support for the view that the statute should receive uniform interpretation and enforcement.

4. *Approval and Shipment From Outside State*

If a foreign corporation is to enjoy immunity under the federal statute, not only must its employees transmit offers out of the state for approval, but also the goods must be shipped from outside the state. Tax liability may result if the seller uses its own delivery vehicles.

Problems also arise in consignment sales. Situations exist in which the goods already are in the taxing state before solicitation occurs. Title remains in the foreign corporation until the goods have been sold by the consignee. Since there is no shipment from outside the state after solicitation, the argument can be made that the seller does not qualify for the protection of the statute.²²

5. *Independent Contractor*

The federal statute provides a person shall not be considered to have engaged in business activities within a state merely by reason of

²⁰ 105 CONG. REC. 15099, 15107 (daily ed. Aug. 20, 1959).

²¹ 46 VA. L. REV. 297, 316 (1960).

²² 46 VA. L. REV. 297, 318 (1960).

sales or the solicitation of orders for sales in the state on behalf of such person by independent contractors.²³

The statute defines "independent contractor" as "a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities."²⁴ Since the statute defines an "independent contractor" in part as an "independent contractor," it is obvious that administrative and judicial interpretation will be required. The distinction between an independent contractor and an employee has been a frequent subject of controversy in such areas as those covered by state unemployment insurance acts, the Social Security Act and the Fair Labor Standards Act. The extent to which precedents under these acts will be used in interpreting this new federal statute remains to be seen.

6. Assessment

The federal statute provides that it shall not be construed to prohibit the collection of any net income tax which was "assessed" on or before the date of enactment of the statute for a taxable year ending on or before such date.²⁵ The question arises as to when a tax is "assessed." For example, a notice may have been sent to the taxpayer prior to the enactment of the federal statute informing the taxpayer it was being assessed a certain amount and that this assessment would become final if the taxpayer did not protest within a specified period of time. Suppose the federal statute was enacted before the time for filing protest had expired.

Another possible situation would be where the agency charged with administering the tax had sent out the notice, had received the protest of the taxpayer, had denied the protest, and the taxpayer had availed itself of the opportunity provided by a particular statute of appealing to another administrative agency for review. Suppose these steps were taken prior to the enactment of the federal statute, but the reviewing administrative agency had not reached its decision by the time the federal statute was enacted.

The California State Board of Equalization recently considered this latter question in the *Appeal of American Snuff Co.*,²⁶ decided April 20, 1960. The taxpayer contended that the word "assessed" should be con-

²³ 73 Stat. 555 (1959); 15 U.S.C.A. § 381(c) (Supp. 1959).

²⁴ 73 Stat. 555 (1959); 15 U.S.C.A. § 381(d) (Supp. 1959).

²⁵ 73 Stat. 555 (1959); 15 U.S.C.A. § 382(b)(2) (Supp. 1959).

²⁶ *Appeal of American Snuff Co.*, CAL. ST. BD. OF EQUAL., April 20, 1960; CCH 3 CAL. TAX CASES ¶ 201-538; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13223.

strued as meaning that the tax was not "assessed" until the assessment became final. In rejecting this contention, the Board, in its opinion, stated:

The federal act does not define "assessed." Nothing in the committee reports or legislative history regarding the act indicates any special definition of the word. . . .

Uniformity in the application of the federal legislation will be best achieved by adherence to the commonly accepted view that the initial determination of a tax by the appropriate administrative agency constitutes an assessment.

The foregoing questions of statutory interpretation, while not exhaustive, are an indication that all problems have not been miraculously solved by the enactment of the federal statute.

II. Due Process Clause

A. Source of Income

The power of a state to tax net income derived from sources within the state is well established, even as to nonresident individuals²⁷ and foreign corporations.²⁸ Foreign corporations, however, may not be taxed on income from sources without the taxing state,²⁹ except possibly corporations having a commercial domicile in the state.³⁰

Since the California tax statutes limit the personal income tax on nonresidents to income from sources within California³¹ and the tax on both domestic and foreign corporations to a tax on or measured by net income derived from sources in California,³² the significance of the statutory phrase "net income derived from or attributable to sources within this state" is apparent.

Consideration, accordingly, will be given to certain types of income in relation to source.³³

²⁷ *Shaffer v. Carter*, 252 U.S. 37 (1920).

²⁸ *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 711, 712-713, 166 P.2d 861, 864, 865-866, *affirmed per curiam*, 328 U.S. 823 (1946); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 464 (1959).

²⁹ *Hans Rees' Sons Inc. v. North Carolina*, 283 U.S. 123 (1931).

³⁰ See notes 52, 53, 57, 68-71 *infra*.

³¹ CAL. REV. & T.C. § 17041.

³² CAL. REV. & T.C. § 25101.

³³ The California Bank and Corporation Tax Law provides:

"Income derived from or attributable to sources within this State includes income from tangible or intangible property located or having a situs in this State and income from any activities carried on in this State, regardless of whether carried on in intrastate, interstate or foreign commerce." CAL. REV. & T.C. § 23040.

For California's treatment of income from intangibles which is part of the unitary income see *Wahrhaftig*, *infra* this issue.

1. *Business Income*

Income from business activities has its source in the state in which those activities are conducted. Thus, income from business activities in California constitutes income from sources in California within the meaning of the statute³⁴ and is constitutionally taxable.³⁵ “. . . Taxation by states in which a corporation carries on business activities is justified by the advantages that attend the pursuit of such activities. . . .”³⁶

Where business activities in more than one state are so interrelated as to constitute a unitary business, that portion of the unitary income reasonably attributable to the taxing state is regarded as having its source in that state and may be taxed.³⁷

2. *Income From Personal Services*

The source of income from personal services generally is regarded as in the state in which the personal services are rendered.³⁸ Nonresident entertainers, professional people, employees and others receiving compensation for services performed in California thus are treated by the California personal income tax regulations as having income from sources within this state.³⁹

3. *Income From Real Estate and Tangible Personal Property*

Income from real estate generally is regarded as having its source in the state in which the real estate is located.⁴⁰ The California personal income tax regulations treat as income from sources in California rents from real or tangible personal property in the state, gains realized from the sale or transfer of such property and any other type of income derived from the ownership, control or management of real and tangible personal property located in the state.⁴¹ The California bank and corporation tax regulations are to the same effect.⁴²

³⁴ CAL. REV. & T.C. § 23040.

³⁵ *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 711, 712-713, 166 P.2d 861, 864, 865-866, *affirmed per curiam*, 328 U.S. 823 (1946); *Northwestern States Portland Cement Co. v. Minnesota*, *supra* at 465.

³⁶ *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 711, 166 P.2d 861, 864 (1946), citing *Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 446 (1940).

³⁷ *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920); *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 238 P.2d 659, *appeal dismissed*, 343 U.S. 939 (1951).

³⁸ *ALTMAN & KEESLING, ALLOCATION OF INCOME IN STATE TAXATION* 68 (2d ed. 1950).

³⁹ 18 CAL. ADM. C. REGS. 17211-17214(e).

⁴⁰ *ALTMAN & KEESLING, ALLOCATION OF INCOME IN STATE TAXATION* 74 (2d ed. 1950). See *New York ex rel Cohn v. Graves*, 300 U.S. 308, 312 (1937).

⁴¹ 18 CAL. ADM. C. REGS. 17211-17214(c).

⁴² 18 CAL. ADM. C. REG. 23040(a).

4. *Income From Intangibles*

This is one of the frontier lands in relation to state power to tax. There is much territory yet to be charted.

Since intangibles do not have a physical location⁴³ they frequently are ascribed a fictional location or situs.

Generally, intangibles are said to have a situs at the domicile of the owner of the intangibles.⁴⁴ Thus intangibles have been held to have a situs at the legal domicile of a corporation.⁴⁵ They also have been held to have a situs at the commercial domicile of a corporation.⁴⁶ Intangibles also under certain circumstances have been held to have a business situs.⁴⁷

The significance for income tax purposes of attributing a situs to intangible personal property is that income is regarded as having a source at the situs of the intangible personal property. Thus, in *Miller v. McColgan*,⁴⁸ the question arose as to the nature of a shareholder's interest in a corporation. The court observed that a shareholder does not own the corporate property but merely owns stock in the corporation. The situs of the stock (an intangible) was held to be at the domicile of the owner and since the stock was the source of the shareholder's income (in the form of dividends), the state in which the shareholder was domiciled was the state in which the income had its source.

In defining income "derived from or attributable to sources" within California, the Bank and Corporation Tax Law expressly includes income from intangible property "having a situs" in the state.⁴⁹

⁴³ "The rule that property is subject to taxation at its situs, within the territorial jurisdiction of the taxing state, readily understood and applied with respect to tangibles, is in itself meaningless when applied to intangibles which, since they are without physical characteristics, can have no location in space. . . . The resort to a fiction by the attribution of a tax situs to an intangible is only a means of symbolizing, without fully revealing, those considerations which are persuasive grounds for deciding that a particular place is appropriate for the imposition of the tax. . . ." *First Bank Stock Corp. v. Minnesota*, 301 U.S. 234, 240 (1937). For a further exposition on the nature of intangibles in relation to taxation see *Curry v. McCanless*, 307 U.S. 357, 365 (1939).

⁴⁴ This results from application of the maxim *mobilia sequuntur personam*. *Miller v. McColgan*, 17 Cal. 2d 432, 439 (1941); *Robinson v. McColgan*, 17 Cal. 2d 423, 425 (1941).

⁴⁵ *Cream of Wheat Co. v. County of Grand Forks*, 253 U.S. 325 (1920); *Rainier Brewing Co. v. McColgan*, 94 Cal. App. 2d 118, 210 P.2d 233 (1949).

⁴⁶ *Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936).

⁴⁷ *Wheeling Steel Corp. v. Fox*, *supra*, note 46; *New Orleans v. Stempel*, 175 U.S. 309 (1899); *State Board of Assessors v. Comptoir National*, 191 U.S. 388 (1903); *Metro-politan Life Ins. Co. v. New Orleans*, 205 U.S. 395 (1907). See *Holly Sugar Corp. v. Johnson*, 18 Cal. 2d 218, 115 P.2d 8 (1941).

⁴⁸ 17 Cal. 2d 432, 110 P.2d 419 (1941).

⁴⁹ CAL. REV. & T.C. § 23040.

The California personal income tax regulations⁵⁰ and bank and corporation tax regulations⁵¹ cover in considerable detail the subject of what income from intangibles constitutes income from sources within the state.

B. Domicile of Corporations—Legal and Commercial

Domicile affords a basis for income taxation of corporations. Two concepts of corporate domicile should be noted—legal and commercial.

The legal domicile of a corporation is the state of incorporation. There is considerable support for the view that the state of legal domicile may tax a corporation on its entire net income.⁵²

Domicile, if limited to the state of incorporation, is an incomplete and unsatisfactory test of state power to tax corporations. It is unrealistic to allow the state where a corporation happens to be incorporated to tax its entire income, even though the corporation may have only a nominal or no office in the state and engage in no activities there, and to deny such power to the state where the corporation has its principal office and in which its affairs are conducted and controlled.⁵³

A growing realization that a state other than the state of legal domicile frequently has a more direct relation to the operations of a corporation than the state of legal domicile, and contributes more to the corporation in the way of opportunities, protection and benefits, has led to the development of the doctrine of commercial domicile. This doctrine emerged in *Wheeling Steel Corp. v. Fox*,⁵⁴ intertwined with

⁵⁰ 18 CAL. ADM. C. REGS. 17211-17214(f).

⁵¹ 18 CAL. ADM. C. REG. 23040(a).

⁵² ALTMAN & KEESLING, ALLOCATION OF INCOME IN STATE TAXATION 33 (2d ed. 1950). Barrett, "Substance" vs. "Form" in the Application of the Commerce Clause to State Taxation, 101 U. PA. L. REV. 740, 755 (1953). See *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 710, 166 P.2d 861, 864, *affirmed per curiam*, 328 U.S. 823 (1946); *Newark Fire Ins. Co. v. State Board*, 307 U.S. 313, 324 (1939) (opinion of Frankfurter, J.); *Rainier Brewing Co. v. McColgan*, 94 Cal. App. 2d 118, 125, 210 P.2d 233, 237, (1949); *Rock Island Refining Co. v. Oklahoma Tax Comm'n*, 193 Okla. 468, 145 P.2d 194 (1943). In the latter case, the Supreme Court of Oklahoma upheld a tax on the entire net income of a domestic corporation engaged in intrastate and interstate commerce. In dismissing an appeal from this decision "for want of a substantial federal question," the United States Supreme Court in a per curiam opinion, *Rock Island Refining Co. v. Oklahoma Tax Commission*, 322 U.S. 711 (1944), cited *Lawrence v. State Tax Commission*, 286 U.S. 276 (1932) and *New York ex rel Cohn v. Graves*, 300 U.S. 308 (1937), thereby indicating the applicability to domestic corporations of decisions upholding the power of the state of domicile to tax the entire net income of individuals.

⁵³ ALTMAN & KEESLING, ALLOCATION OF INCOME IN STATE TAXATION 64-65 (2d ed. 1950).

⁵⁴ 298 U.S. 193 (1936); *Sinclair Pipe Line Co. v. State Com'n of Revenue & Tax*, 184 Kan. 713, 339 P.2d 341 (1959); Ramsey, *A New Theory of Corporate Domicile for Tax Purposes*, 23 AM. BAR ASSN. J. 543 (1937); 35 MICH. L. REV. 1032 (1937).

language about business situs of intangibles.⁵⁵ It seems apparent from later decisions, however, that commercial domicile and business situs are separate concepts. It has been held, for example, that commercial domicile is a basis for taxation of income from intangibles even though the intangibles do not have a business situs in the taxing state.⁵⁶

The doctrine of commercial domicile has found acceptance in California and has been applied in cases involving the corporation franchise tax (measured by net income).⁵⁷

What factors tend to establish commercial domicile? The commercial domicile of a corporation has been variously described as the state in which was located the "real center of its business activity,"⁵⁸ the "headquarters for the transaction of business,"⁵⁹ the principal office from which its management was conducted,⁶⁰ the place where the corporation was "localized as to control and management,"⁶¹ the place where the corporation was managed and operated,⁶² "the state where, under the facts, the corporation receives its greatest protection and benefits, that state where the greatest proportion of its control exists,"⁶³

⁵⁵ Comparable language is found in *First Bank Corp. v. Minnesota*, 301 U.S. 234, 237 (1937).

⁵⁶ *Chestnut Securities Co. v. Oklahoma Tax Commission*, 125 Fed. 2d 571 (10th Cir. 1942), *cert. denied*, 316 U.S. 668 (1942). Cases not involving business situs of intangibles in which the United States Supreme Court has attributed significance to commercial domicile include *Southern Gas Corp. v. Alabama*, 301 U.S. 148 (1937) and *Memphis Natural Gas Co. v. Beeler*, 315 U.S. 649 (1942).

⁵⁷ *Pacific Western Oil Corp. v. Franchise Tax Bd.*, 136 Cal. App. 2d 794, 289 P.2d 287, *appeal dismissed*, 352 U.S. 805 (1955); *Southern Pac. Co. v. McColgan*, 68 Cal. App. 2d 48, 156 P.2d 81 (1945). The following interesting observation concerning commercial domicile appears in a footnote to the dissenting opinion in *Flying Tiger Line, Inc. v. County of Los Angeles*, 51 Cal. 2d 314, 328, 333 P.2d 323 (1958) (a property tax case): "Although the state of incorporation is regarded as the legal domicile of a corporation, its domicile for tax purposes is its principal place of business or headquarters. Thus, the 'commercial domicile' rather than the state of incorporation is given the power to tax intangible property of the corporation on the ground that 'it is there that the owner in every practical sense realizes the economic advantages of his ownership.' *First Bank Stock Corp. v. Minn.*, 301 U.S. 234, 241; see *Wheeling Steel Corp. v. Fox*, 298 U.S. 193; *Southern Pac. Co. v. McColgan*, 68 Cal. App. 2d 48; *Pacific Western Oil Corp. v. Franchise Tax Bd.*, 136 Cal. App. 2d 794 . . ."

⁵⁸ GOODRICH, *CONFLICT OF LAWS* 134 (3d ed. 1949).

⁵⁹ *Southern Gas Corp. v. Alabama*, 301 U.S. 148, 153 (1937).

⁶⁰ *Ibid.* "Appellant made Birmingham, Alabama, its headquarters for the transaction of business. The 'entire management' was conducted from its principal office at that place. There, as the state court said, was 'the control of the business in all of its aspects.' There orders for deliveries of gas under its contracts and all collections from sales were received and all disbursements were made or authorized. While Delaware was the state of incorporation, appellant's commercial domicile was in Alabama. *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 211."

⁶¹ 35 MICH. L. REV. 1032, 1033 (1937).

⁶² *Smith v. Ajax Pipe Line Co.*, 87 F. 2d 567 (8th Cir. 1937).

⁶³ *Southern Pac. Co. v. McColgan*, *supra*, note 57, at 81. ". . . We perceive the law

the state where the corporation maintains its general business offices, the "center of authority," "the actual seat of its corporate government."⁶⁴

In *Southern Pacific Co. v. McColgan*,⁶⁵ the court stated that the place where the board of directors met was an important, but not conclusive, factor in determining where the commercial domicile of the corporation was located. In that case, the court held the commercial domicile was in California even though the board of directors met in New York.⁶⁶ In so holding, the court said:⁶⁷

The true test must be to consider all the facts relating to the particular corporation, and all the facts relating to the intangibles in question, and to determine from those facts which state, among all the states involved, gives the greatest protection and benefits to the corporation, which state, among all the states involved, from a factual and realistic standpoint is the domicile of the corporation. That is partially a question of fact and partly a question of law.

It has not yet definitely been established by United States Supreme Court decision whether the same consequences flow from commercial domicile as from legal domicile.⁶⁸ That court has not yet squarely held,

to be that where the corporation has only a paper domicile, where the only function performed by the state of incorporation is to breathe life into the corporation, and where no substantial corporate activities are thereafter carried on in that state, then the law looks at such corporation and says that that state where, under the facts, the corporation receives its greatest protection and benefits, that state where the greatest proportion of its control exists, that state shall be the commercial domicile, with constitutional power to tax income from intangibles. . . ."

⁶⁴ *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 211-212. "The Corporation established in West Virginia what has aptly been termed a 'commercial domicile.' It maintains its general business offices at Wheeling and there it keeps its books and accounting records. There its directors hold their meetings and its officers conduct the affairs of the Corporation. There, as appellant's counsel well says, 'the management functioned.' The Corporation has manufacturing plants and sales offices in other States. But what is done at those plants and offices is determined and controlled from the center of authority at Wheeling. The Corporation has made that the actual seat of its corporate government." *Ibid.*

⁶⁵ 68 Cal. App. 2d 48, 156 P.2d 81 (1945).

⁶⁶ "... That the state where ultimate control is exercised is not necessarily the commercial domicile is implicit in the holding in *Smith v. Ajax Pipe Line Co.*, 87 F. 2d 567, where the stock of the corporation involved was wholly owned, and therefore the corporation was ultimately controlled, by a holding company located outside the taxing state. When a corporation severs its ties in the state in which it is incorporated and engages in no corporate activities there, but engages in activities elsewhere, the contention that, as a matter of law the only state that can possibly be held to be its commercial domicile is that state where its board of directors meets, is as unrealistic, unsound and artificial as the concept that the corporation for all tax purposes is domiciled in the state of incorporation. It was to free the law from this last mentioned artificial and fictional concept that the concepts of business situs and commercial domicile were applied by the courts" 68 Cal. App. 2d at 79, 156 P.2d at 99.

⁶⁷ 68 Cal. App. 2d at 80, 156 P.2d at 99.

⁶⁸ "... Whether the commercial domicile is on a parity with the legal domicile, whether its power to tax is the same as that of the legal domicile, or whether it becomes

for example, that a state in which a corporation has a commercial domicile can, on that basis alone, tax its entire net income.⁶⁹ It has been held by a lower federal court that a state of commercial domicile may tax the income from intangibles even though there is neither physical location of the evidence of ownership of the intangibles nor business situs of the intangibles within the state.⁷⁰ It has also been suggested by way of dictum that the state of commercial domicile may have power to tax all the corporation's income.⁷¹

Despite the apparent power of the state of legal domicile, and possibly of the state of commercial domicile, to tax the entire net income of a corporation, states having net income taxes generally have not attempted to exercise such broad power but have taxed only net income derived from sources within the taxing state.⁷² The California statute so provides.⁷³ By application of the maxim *mobilia sequuntur personam* most states tax corporations having a legal or commercial domicile in the state on income from intangibles.⁷⁴

C. Residence — Significance and Meaning

Domicile provides a constitutional basis for taxation of individuals on their net income.⁷⁵ A state, therefore, may constitutionally tax a person domiciled in the state upon income from rents of land located outside the state.⁷⁶ Persons domiciled in the state also may be taxed on income derived from *activities* in other states.⁷⁷

a complete substitute for the technical domicile for tax purposes, are questions not yet decided by the United States Supreme Court, and not involved in this case. . . ." *Southern Pacific Co. v. McColgan*, 68 Cal. App. 2d 48, 81, 156 P.2d 81, 100 (1945).

⁶⁹ In *Southern Pacific Co. v. McColgan*, and *Pacific Western Oil Corp. v. Franchise Tax Board*, *supra*, note 57, the courts did not find it necessary to decide whether income from all intangibles owned by a corporation could be taxed by the state of commercial domicile since in those cases the intangibles in question were found to be reasonably connected with the main business of the corporation.

⁷⁰ *Chestnut Sec. Co. v. Oklahoma Tax Com.*, 125 Fed. 2d 571, (10th Cir. 1942) *cert. denied*, 316 U.S. 668 (1942). See *ALTMAN & KEESLING, op. cit.* note 52, at 34.

⁷¹ *Ibid.*

⁷² *ALTMAN & KEESLING, op. cit.* note 52, at 61.

⁷³ CAL. REV. & T. C. § 25101.

⁷⁴ *ALTMAN & KEESLING, op. cit.* note 52, at 62. Foreign corporations not commercially domiciled in the state are taxable on income from intangibles only if the intangibles are so used in connection with a trade or business therein as to acquire a business situs. *ALTMAN & KEESLING, op. cit.* note 52, at 62.

⁷⁵ *Lawrence v. State Tax Commission*, 286 U.S. 276 (1932).

⁷⁶ *New York ex rel Cohn v. Graves*, 300 U.S. 308 (1937).

⁷⁷ *Lawrence v. State Tax Commission, supra* note 75. ". . . [I]ncome may be taxed both by the state where it is earned and by the state of the recipient's domicile. Protection, benefit and power over the subject matter are not confined to either state. . . ." *State Tax Commission v. Aldrich*, 316 U.S. 174, 178 (1942), quoting from *Curry v. McCannless*, 307 U.S. 357, 368 (1939).

"Domicile" includes the element of intention to make a place one's home, while "residence" frequently is used to refer only to the physical fact of living in a place.⁷⁸ In many instances domicile and residence coincide. There may be circumstances, however, in which a person is domiciled in a state though he does not reside there and, conversely, in which a person may reside in a state though he is not domiciled there.⁷⁹ Absence of intention to remain indefinitely or a present intention sometime to return to a former residence prevents the acquisition of a new domicile but not a new residence.⁸⁰

A person who is domiciled in a state does not lose that domicile until he has acquired a new one. Acquisition of a new domicile requires both act and intent. Thus, acquisition of a new domicile in another state requires not only that the person be present there but also that he have an intention to make his permanent home there and to abandon his former home.⁸¹

Domicile alone has been found unsatisfactory as a basis for personal income taxation. A person may live in a state for a long period of time, enjoying protection and benefits, without becoming domiciled in the state. On the other hand, a person may continue to be domiciled in a state, though residing elsewhere for an extended period. Residence, moreover, is determined largely upon objective considerations, such as the duration of a person's stay in the state and the nature of his activities there, whereas domicile involves the subjective consideration of intent. Residence, accordingly, provides a fairer and more workable basis for income taxation than domicile.⁸²

California has a statutory definition of "resident" which includes an individual who is in the state for other than a temporary or transitory purpose, or who is domiciled in California but is out of the state for only a temporary or transitory purpose.⁸³ The California statute does not purport to impose a tax on individuals who are domiciled in the state but are residing permanently elsewhere, except as to income derived from sources within the state.⁸⁴ Within the concept of the

⁷⁸ ALTMAN & KEESLING, *op. cit.* note 52, at 31. See 3 WITKIN, SUMMARY OF CALIFORNIA LAW, 2415 (1960); Reese and Green, *That Elusive Word, "Residence,"* 6 VAN. L. REV. 561, 575 (1953).

⁷⁹ Keesling, *The Problem of Residence in State Taxation of Income*, 29 CALIF. L. REV. 706, 720 (1941).

⁸⁰ Keesling, *supra* note 79, at 727.

⁸¹ Keesling, *supra* note 79, at 721.

⁸² ALTMAN & KEESLING, *op. cit.* note 52, at 41-55; Keesling, *supra* note 79, at 726-729.

⁸³ CAL. REV. & T.C. § 17014.

⁸⁴ CAL. REV. & T.C. §§ 17014, 17015, 17041.

statute, residence once established in a state is not lost by temporary absences therefrom.⁸⁵

There is a statutory presumption that an individual is a resident if he spends in the aggregate more than nine months of a taxable year in California.⁸⁶ The presumption may be overcome, however, by satisfactory evidence that the individual is in the state for only a temporary or transitory purpose.⁸⁷

Although there is a statutory presumption of residence if an individual spends more than nine months of a taxable year in California, this does not mean that an individual may not be a "resident" within the meaning of the statute simply because he does not spend nine months of a particular taxable year in the state.⁸⁸ All the pertinent facts must be considered.⁸⁹

The California tax is imposed upon the entire taxable income of residents and upon the income of nonresidents derived from sources within California.⁹⁰

The California appellate courts have not had occasion to construe the scope of the term "resident" for purposes of the personal income tax. The statutory provision has been the subject, however, of numerous opinions of the California State Board of Equalization.⁹¹ It also has been interpreted in considerable detail in the California Personal Income Tax Regulations.⁹²

The opinions of the United States Supreme Court in *Lawrence v. State Tax Commission*⁹³ and *New York ex rel Cohn v. Graves*,⁹⁴ though concerned with domicile, indicate that residence as defined by the California statute is an adequate basis to sustain taxation.

D. Foreign Trusts and Estates

The general practice of states which tax net income of estates and trusts is to follow the broad outlines of the Internal Revenue Code of 1954. Thus, income which is currently distributed or distributable to the beneficiaries is taxable to them. Income which is accumulated is

⁸⁵ CAL. REV. & T.C. § 17014.

⁸⁶ CAL. REV. & T.C. § 17016.

⁸⁷ *Ibid.*

⁸⁸ 18 CAL. ADM. C. REGS. 17013-17015(e).

⁸⁹ BOCK, 1960 GUIDEBOOK TO CALIFORNIA TAXES, ¶103.

⁹⁰ CAL. REV. & T.C. § 17041. The tax under certain circumstances is reduced by a credit for net income taxes imposed by and paid to another state. CAL. REV. & T.C. §§ 18001, 18002.

⁹¹ See annotation to CAL. REV. & T.C. § 17014 in Revenue Laws of California (State Board of Equalization, 1959).

⁹² CAL. ADM. C. REGS. 17013-17015(a) to (f).

⁹³ *Lawrence v. State Tax Commission*, 286 U.S. 276 (1932).

⁹⁴ *New York ex rel Cohn v. Graves*, 300 U.S. 308 (1937).

taxable to the estate or trust.⁹⁵ California follows this method.⁹⁶

The discussion which follows concerns trusts and estates which have some out-of-state element such as a nonresident trustee or beneficiary.

1. *Trusts*

a. Distributed or Distributable Income

Resident beneficiaries are taxed by California on trust income currently distributed or distributable to them regardless of whether the corpus of the trust is located within or without the state and regardless of whether the trustee is a resident or nonresident.⁹⁷ The constitutionality of such taxation is established.⁹⁸

Nonresident beneficiaries are taxed on trust income currently distributed or distributable to them if the income is derived from sources in California.⁹⁹ There appears to be adequate support for the constitutionality of this statutory provision.¹⁰⁰ The California Personal Income Tax Law provides that distributed or distributable trust income is income from sources within California only if distributed or distributable out of income of the trust derived from sources within California.¹⁰¹ For purposes of determining the source of the income, the nonresident beneficiary is deemed to be the owner of intangible personal property from which the income of the trust is derived.¹⁰²

b. Accumulated Income

Trusts are taxed upon all income accumulated in trust or held for future distribution, regardless of the source from which derived, if the trustee or the beneficiary is a resident of California.¹⁰³ If, however, the trustee and beneficiary are nonresidents, such income is taxed only if derived from sources within the state.¹⁰⁴

The constitutional validity of a tax by the state of residence of the trustee on accumulated net income appears to have acceptance by the

⁹⁵ ALTMAN & KEESLING, *ALLOCATION OF INCOME IN STATE TAXATION* 56 (2d ed. 1950); Traynor, *State Taxation of Trust Income*, 22 IOWA L. REV. 268 (1937).

⁹⁶ CAL. REV. & T.C. §§ 17742, 17751, 17752, 17761 and 17762.

⁹⁷ CAL. REV. & T.C. §§ 17071(15), 17752, and 17762.

⁹⁸ *Guaranty Trust Co. v. Virginia*, 305 U.S. 19 (1938); 52 HARV. L. REV. 326 (1938). Cf. *Lawrence v. State Tax Comm'n*, 286 U.S. 276 (1932); *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937).

⁹⁹ CAL. REV. & T.C. §§ 17752(d), 17762(d) and 17953.

¹⁰⁰ Cf. *Shaffer v. Carter*, 252 U.S. 37 (1920).

¹⁰¹ CAL. REV. & T.C. § 17953.

¹⁰² *Ibid.*

¹⁰³ CAL. REV. & T.C. §§ 17041, 17731, 17742. See § 17745 (liability of beneficiaries for tax on income taxable to trust).

¹⁰⁴ *Ibid.*

United States Supreme Court.¹⁰⁵ The Court, however, has not yet had occasion to decide the validity of a tax with respect to accumulated income where the trustee is a nonresident and the tax is founded on residence of the beneficiary.¹⁰⁶

The California statute contains special provisions for situations in which there are two or more trustees or two or more beneficiaries, one or more of whom reside in California while the others reside outside the state.¹⁰⁷

2. *Estates*

If the decedent was a resident of California at the time of his death, all of the estate's taxable income is taxed by California.¹⁰⁸ If the decedent was a nonresident, income of the estate from California sources is taxed to the estate¹⁰⁹ unless the income is distributed or distributable to California beneficiaries.¹¹⁰ Any income distributed or distributable to a beneficiary who is a California resident is taxed to the beneficiary, regardless of the source of the income.¹¹¹

Income of estates distributed or distributable to nonresident beneficiaries is regarded as income from sources within California only if distributed or distributable out of income of the estate derived from sources within California.¹¹² For purposes of determining the source of the income, the nonresident beneficiary is deemed to be the owner of the intangible personal property from which the income of the trust is derived.¹¹³

III. Conclusion

State tax laws generally survive attack under the commerce clause and due process clause of the federal commerce if they do not discriminate against interstate commerce,¹¹⁴ if the proper "constitutional channel"¹¹⁵ is selected for the incidence of the tax and if there exists

¹⁰⁵ See *Guaranty Trust Co. v. Virginia*, 305 U.S. 19, 23. Cf. *Greenough v. Tax Assessors*, 331 U.S. 486 (1947).

¹⁰⁶ See 31 Ops. Cal. Atty. Gen. 234 (1958); Traynor, *State Taxation of Trust Income*, 22 IOWA L. REV. 268 (1937).

¹⁰⁷ CAL. REV. & T.C. §§ 17743, 17744. See *Greenough v. Tax Assessors*, 331 U.S. 486 (1947).

¹⁰⁸ CAL. REV. & T.C. § 17742.

¹⁰⁹ CAL. REV. & T.C. §§ 17041, 17731(b).

¹¹⁰ CAL. REV. & T.C. § 17761. "Beneficiary" is defined as including heir, legatee and devisee. CAL. REV. & T.C. § 17742.

¹¹¹ CAL. REV. & T.C. §§ 17041, 17762.

¹¹² CAL. REV. & T.C. § 17953.

¹¹³ *Ibid.*

¹¹⁴ See *Spector Motor Service v. O'Connor*, 302 U.S. 602, 607 (1951).

¹¹⁵ *Id.* at 608.

“some definite link, some minimum connection” constituting a “nexus”¹¹⁶ between the state and the person, property or transaction it seeks to tax.

What the United States Supreme Court might regard as the minimum contact or activity in the taxing state sufficient to sustain state power to tax net income may not be known in the area of sales of tangible personal property by out-of-state vendors because of the intervention of federal legislation (Public Law 86-272). This legislation presents a number of questions of statutory interpretation.

Certain realistic trends are observable in the development of the doctrine of commercial domicile as a basis for taxation of corporations and in the emphasis upon residence in the taxation of individuals.

Despite the many years of state taxation of net income and the considerable body of litigation which has ensued all the answers have not yet been provided nor is it reasonable to anticipate they ever will be in this dynamic relationship between the individual or the business community and state government.

¹¹⁶ *Scripto v. Carson*, 362 U.S. 207, 210-211 (1960).